Discussion of the federal budget has featured much doom-mongering. This is exemplified by forecasts of a A$6-8 billion black hole in 2015-16, when the carbon tax switches to an emissions trading scheme linked with Europe. The government estimates revenue will be A$2.5 billion lower than previously forecast, thanks to revised projections for European carbon prices included in the forward estimates.

The Coalition is framing the election as a referendum on the carbon tax, and emphasising this so-called “carbon budget black hole”.

Should we take these forecasts and related claims about the near-collapse of the European carbon market seriously?

**It’s been high before; it can be high again**

How quickly we forget that two years ago the EU carbon price was above A$20 per tonne (and well above this price in 2006 and 2008). Around the time it was A$20 per tonne the government was negotiating a starting carbon price. The updated Garnaut Review recommended a starting price of $20 to $30 a tonne, and a price towards the lower end was agreed by the multi-party climate change committee.

When the Australian carbon price package was initially negotiated, no one forecast the current price, or a major market crash. (Although as the package passed our Houses of Parliament late 2011 some analysts were warning that the market could crash in the near-future.)

Previously, Treasury modelling projected a European price of A$29 in 2015-16. Consequently, in the legislation, the Australian carbon price has been scheduled to move towards this price in the lead-up to linking with Europe.

Now – with the European carbon price at A$3-$4 a tonne – some experts are confidently telling us that the price will remain around current levels or continue falling to closer to A$2.

According to a Reuters poll, most experts think it will be A$8.50. Treasury’s latest forecast is slightly higher, forecasting a price around A$12 a tonne in 2015-16.

All these forecasts express the current zeitgeist. They project forwards the current pessimism about Europe and its carbon market.

**Reasons to be sceptical: human biases and political motivations**

Forecasts are shaped by the interpretations and biases of whoever made them. Psychological studies have revealed many cognitive biases that affect how we predict the future.

Harvard’s Daniel Gilbert calls one set of biases “presentism”, because imagined futures often look “so much like the actual present”. How we feel now affects how we view the past and imagine the future.

A striking example is that by manipulating the temperature of the room peoples' views on global warming are influenced. Similarly thirst levels impacted forecasts of drought and desertification. Our brains have evolved to focus on near and immediate events or threats. Some scientists suggest natural selection played a role in developing such traits.

“Zeitgeist bias” explains that forecasts often tell us more about the time they were created than the future they
were intended to shed light on. It’s hard to see and think beyond current issues and preoccupations.

For these reasons management practices like scenario planning try to break the mental habit of thinking the future will look much like the present. Sometimes it will, often it won’t.

Political commitments and ideologies are perhaps also at play. Australian economist Paul Frijters argues the Australian Treasury made a serious mistake by relying on “the politically-motivated projections” of the European Commission. Now, vested interests and politicians opposed to the carbon tax enthusiastically promote forecasts of budget “black holes”.

It is also commonly argued that political interference shapes modelling and forecasts, particularly those of the Australian Treasury. That is, “he who pays the piper calls the tune”.

**Reality checks**

In early 2011, no one forecasted the recent market crash. Similarly no one knows what the European carbon price will be in 2015-16.

While the media loves an uber-confident pundit, this misses the reality that the future is not yet written and is still uncertain.

Many factors contributed to the price crash, including a surplus of emissions permits and a range of economic factors. The European carbon price peaked pre-GFC and has since declined, as the slump slowed industrial activity and contributed to depressed prices. The perilous state of the EU economy also complicates political processes to reform the EU Emissions Trading Scheme.

Similarly, many factors will influence the future price of carbon permits. For example, we know politically there are plans to reintroduce legislation to address the over-supply of permits. This is intended to be a precursor to more fundamental reforms (see options being considered). The economic recovery process will also shape demand-side factors.

There are limits and risks to basing a decision or policy on a particular forecast. This lesson was learnt long ago in the business world. It should be learnt in Canberra. The Gillard Labor Government, instead, has tended to turn shaky projections into solemn promises.

If Australia’s carbon price is not repealed, policy-makers face a choice. They could “wait and see”. Or instead they could modify legislation and policies so they have more flexibility.

Commentary on the European carbon price is mostly politically opportunistic. We simply don’t know if the planned linkage with Europe will generate a budget “black hole”. Those saying it’s a certainty have political motivations. In fact, a Coalition Government may have a larger carbon budget hole to deal with if it wins office.